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No. ______

In The

Supreme Court of the United States

October Term, 1986

KATHRYN B. CELAURO
as successor in interest to

MARTHA B. OLSEN, COMMISSIONER OF REVENUE,
STATE OF TENNESSEE

Petitioner

vs.

MIDLAND BANK & TRUST COMPANY, ET AL.,

Respondent.

On Petition For A Writ of Certiorari
To The Supreme Court
Of Tennessee

PETITION FOR WRIT OF CERTIORARI

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55 pp

QUESTIONS PRESENTED

1. If a state tax provides for the exemption of federal bonds and their income from direct or indirect taxation, is the taxpayer holding those bonds also entitled under the Federal Immunity Doctrine and 31 U.S.C. §3124(a) to additional affirmative benefits at the expense of the state's taxing power?

2. Is a state tax nondiscriminatory under the Federal Immunity Doctrine and the terms of 31 U.S.C. §3124(a) when state bonds are exempted from taxation and some holders of those bonds are given an affirmative tax benefit, such as a tax shelter, whereas federal bonds are entirely exempted but do not have an identical affirmative benefit.

PARTIES

The parties before The Court are the Petitioner, Kathryn B. Celauro, as successor in interest to Martha B. Olsen, Commissioner of Revenue and the Respondents, Midland Bank & Trust Company, Union Planters National Bank, National Bank of Commerce, Commercial and Industrial Bank.

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On Petition For A Writ of Certiorari To The Supreme Court Of Tennessee

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The Petitioner, Kathryn B. Celauro as successor in interest to Martha B. Olsen, Commissioner of Revenue, respectfully requests that a Writ of Certiorari issue to review the judgment and opinion of The Supreme Court of The State of Tennessee entered in this proceeding on September 29, 1986.

OPINION BELOW

The opinion of the Supreme Court of Tennessee is reported at 717 S.W.2d 580 and appears as Appendix A, pp. A1 to A-8, infra.

JURISDICTION

The decision of the Supreme Court of Tennessee was entered on September 29, 1986 and this Petition for Certiorari was filed within ninety (90) days of that date. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1257(3).

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

United States Constitution, Article VI, Clause 2:

This Constitution, and the laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

United States Constitution, Article I, Section 8, Clause 2:

Section 8. The Congress shall have the Power . . . to borrow money on the credit of the United States . . . .

31 U.S.C. s3124(a):

Stocks and obligations of the United States Government are exempt from taxation by a state or political subdivision of a state. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both to be considered in computing a tax, except

(i) a nondiscriminatory franchise tax or other non-property tax instead of a franchise tax, imposed on a corporation; and

(ii) an estate or inheritance tax.

Tennessee Code Annotated Section No. 67-2704. This statutory provision is reproduced in Appendix, p. A-21.

STATEMENT OF THE CASE

This case involves the validity of a state franchise tax after federal bond income has been removed from its tax base. At issue is whether 31 U.S.C. §3124(a) requires only the exemption and removal of federal bond income from the tax base or does this section also require the implication of tax shelters or other affirmative benefits for holding federal bonds which are identical to tax shelters enjoyed by a limited number of taxpayers holding state bonds.

Under Tennessee law as it existed in 1982, Tenn. Code Ann. §67-2701 et seq. imposed a corporate excise tax on all corporations doing business in Tennessee. This tax was measured by the net earnings of a corporation as defined in Tenn. Code Ann. §67-2704. At that time, the Commissioner applied this statute to require the inclusion of net income from federal bonds in the tax base, however, income from Tennessee state and local obligations was not included in the tax base.

In January of 1983, this Court held a similar state tax, the Tennessee Bank Excise Tax, Tenn. Code Ann. §67-751, discriminatory and in violation of the immunity of federal obligations as provided by 31 U.S.C. §3124(a) when the tax was imposed on federal bond income but not on income from comparable state and local bonds. *Memphis Bank and Trust Co. v Garner,* 459 U.S. 392,398-399 (1983)

For the 1982 tax year, the Respondents included net federal bond income in their net earnings tax base and paid their estimated tax payments on these net earnings and their net earnings from other sources. On June 30, 1983, the Respondents filed suit to recover the Corporate Excise taxes paid on federal bond income for the tax year 1982. In a Motion for Summary Judgment the Respondents requested a refund of $893,132 which was calculated by deducting the gross income from federal bonds from the net

earnings tax base. When the gross federal bond income is deducted from the net earnings from all sources, the Respondents would owe no excise taxes because the gross deduction eliminates all of the net earnings tax base for each Respondent.[1]

The Petitioner conceded that Respondents were entitled to a refund but urged that the refund was limited to the taxes paid on net federal bond income since only the net amount of federal bond income had been taxed.

The Respondents claimed that a deduction of the gross amount of federal bond income was necessary to eliminate from the excise tax base the type of discrimination found in *Memphis Bank*. The Respondents further claimed that even if the net amount of income from federal bonds was removed from the tax base, the discrimination would remain because they were not also provided for their holdings of federal bonds a tax shelter which was similar to the limited tax shelter relative to state bonds.

To demonstrate how this referenced tax shelter occurs, the operation of the Tennessee Excise Tax statute must be examined in some detail. The operation of the statute on its face provides that net federal bond income and net state bond income are to be excluded from the net earnings tax base. The Excise Tax is imposed on the "net earnings" tax base which is defined as "federal taxable income" subject to certain adjustments which are not relevant in this case. The Tennessee Excise Tax requires by Tenn. Code Ann. §67-2704(b)(2)(B) the subtraction from "federal taxable

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[1]The deduction of this income for each Respondent is shown in the following table.

	Gross Federal Bond Income	Net Income from All Sources	Net Earnings after Gross Deduction
Midland	$6,401,660	$1,154,371	($5,140,192)
Union	$9,461,734	$7,576,964	($1,884,770)
National	$4,280,079	$4,014,095	($265,079)
Commercial	$2,877,785	$2,140,115	($773,670)

income" of any amount included in federal taxable income which is not taxable by Tennessee. Net federal bond income is included in "net earnings" by virtue of being included in the calculation of "federal taxable income". Since *Memphis Bank* indicates that federal bond income is not properly taxable when Tennessee bond income is not taxed, Tenn. Code Ann. §67-2704(b)(2)(B) requires that the net income from federal bonds must be removed from the net earnings tax base. This requirement applies to all corporations subject to the excise tax.

The Tennessee statute also requires that net Tennessee bond income be removed from the net earnings tax base. The net Tennessee bond income is excluded from the net earnings tax base since it is excluded from "federal taxable income" by virtue of the operation of two provisions of the Internal Revenue Code. I.R.C. §103 provides that the gross income from state and local bonds issued for public purposes is excluded from gross federal income. For all corporations, I.R.C. §265, however, disallows the deduction of the interest expenses directly connected with an indebtedness incurred to carry tax exempt state bonds. Thus, if a taxpayer borrows to buy tax exempt bonds or borrows against tax exempt bonds already owned, interest expenses incurred are not deductible. The result of the operation of these two provisions is the exclusion of net state bond income.

In the practical operation of Section 265, however, a bank is permitted to invest depository funds and its short-term borrowings in tax exempt state and local bonds and is permitted to deduct the interest expenses associated with these borrowings.[2] The practical consequence of this

[2]Rev. Proc. 72-18, Section 4.01 provides that generally a purpose to carry tax exempt obligations will be inferred, unless rebutted by other evidence, whereever a business taxpayer has an outstanding indebtedness which is incurred or continued in connection with a borrowing that is in excess of business needs

application of Section 265 is that banks enjoy a tax shelter of admittedly taxable income which is limited to the expenses related to state and local bonds purchased with depository or similar funds. This tax shelter occurs because the banks exclude gross state and local bond income pursuant to Section 103, but the interest expenses associated with those investments of depository funds are not disallowed by Section 265.[3] This tax shelter applies only to banks which constitute .5% of all corporations subject to the excise tax.

The Petitioner argued that the Tennessee Excise Tax complies with 31 U.S.C. §3124(a) when Tenn. Code Ann. §67-2704(b)(2)(B) requires the subtraction from "federal

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and the taxpayer owns tax exempt securities. This inference will be made even though the indebtedness is ostensibly incurred or continued to purchase or carry other portfolio investments. Rev. Proc. 72-18, 1972-1 C.B. 740.

For banks, this inference will not be drawn with respect to interest paid or accrued by banks on borrowings incurred in the ordinary course of a bank's day-to-day business unless there are circumstances demonstrating a direct connection between the borrowing and the tax-exempt interest. Section 3.09, Rev. Proc. 70-20, 1970-2 C.B. 499

[3]Congress recognized this situation and enacted Section 291(a)(3), I.R.C., as part of the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248), which for financial institutions reduced by 15% the deduction of interest expenses on any indebtedness incurred to carry tax exempt obligations acquired after December 31, 1982. P.L. 98-369 increased the reduction under this section to 20%, effective January 1, 1985.

In The President's Tax Proposal To the Congress for Fairness, Growth, and Simplicity, submitted to Congress in May of 1985 the Treasury Department pointed out that this special treatment permitted banks to offset tax on nonexempt income by the deduction of the interest paid on depository funds. This Proposal is reproduced in part in Appendix pp. A-24 to A-28. Also reprinted in Federal Tax Reports Special 4, Extra Edition, May 29, 1985 (CCH).

taxable income" of the net amount of federal bond income, i.e., the exclusion of the amount of federal bond income that was included in the tax base and thus taxed.[4] The Petitioner calculated that amount using a prorata method similar to the one used in *First National Bank of Atlanta v Bartow County Assessor*, 470 U.S. 583 (1985) and determined the appropriate refund to be $19,033.[5]

The Petitioner further argued that the gross deduction of federal bond income as claimed by the Respondents resulted in a double deduction of the expenses associated with federal bond income because these expenses were initially deducted in computing "federal taxable income." Thus, a gross deduction would provide a tax shelter for admittedly taxable income which would be in addition to the immunity of federal bond income. The Petitioner argued that this Court had specifically ruled out the possibility that 31 U.S.C. §3124(a) could be used to imply such tax shelter benefits in *First National Bank of Atlanta v Bartow County Tax Assessors, supra.*

The Trial Court held that the refund of taxes paid should be determined by the deduction of the gross amount of federal bond income from the net earnings tax base rather than the deduction of the net amount of federal bond income. The court concluded that 31 U.S.C. §3124(a) and

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[4]The Petitioner also raised additional and alternative defenses, however, those defenses are not at issue here.

[5]To calculate the net income from federal obligations, the Petitioner used the following prorata calculation: First, the ratio of gross federal bond income to gross federal income (Line 11, Form 1120, U.S.Corporation Income Tax Return) yields the percentage of gross income which consists of federal bond income. Second, the net earnings of the bank before the Tennessee adjustments, i.e., "federal taxable income," Line 28, Form 1120, U.S. Corporation Income Tax Return, is multiplied by the above percentage to determine the portion of net earnings attributable to federal bond income.

the Constitution require the gross deduction of federal bond income to remove the discrimination in favor of Tennessee obligations. Appendix, pp. A-11 to A-12.

On appeal, the Tennessee Supreme Court affirmed the holding of the Trial Court. The rationale of the Tennessee Supreme Court was that *Memphis Bank* required "identical treatment" of federal and state bond income in the determination of the amount of the exclusion necesary to satisfy the requirements of 31 U.S.C. §3412(a). Appendix, p. A-5. The Court said that *First National Bank of Atlanta v Bartow County Tax Assessor*, supra, was not applicable to determine the amount of the exemption required under 31 U.S.C. s3124(a) because *Bartow* dealt with a nondiscriminatory property tax. Appendix pp. A-4 to A-5.

REASONS FOR GRANTING THE WRIT

This Court should grant this petition for two reasons. First, the decision of the Tennessee Supreme Court is in conflict with this Court's decision in *First National Bank of Atlanta v Bartow County Tax Assessors, supra*. By virtue of this conflict, the decision interposes a limitation on the states' taxing power which was not intended by Congress, by this Court's decision in *Memphis Bank*, nor is it required by the Constitution.

Second, the Tennesse Supreme Court's decision is a departure from the past application of the federal immunity doctrine and imposes a new restriction on the sovereign rights of the states to structure their tax systems. The correction of the Tennessee Supreme Court's misapplication of *Memphis Bank* will necessarily involve an important determination of the scope of this Court's decision in *First National Bank of Atlanta v Bartow County Tax Assessors, supra*. This determination will, in turn, resolve an issue of great importance to the all the states, i.e., the extent to which the federal immunity doctrine as codified in 31 U.S.C. §3124 restricts the states in the exercise of their taxing power in the event that the states exempt federal bonds and their income from taxation.

1. The Tennessee Supreme Court's Misapplication of This Court's Decision in *Memphis Bank* is in Conflict with *First National Bank of Atlanta v Bartow County Tax Assessor*.

The question of how a state should eliminate federal obligations from a state tax base was addressed and settled by this Court's decision in *Bartow*. The Tennessee Supreme Court, however, has disregarded that decision and established a new standard for the exemption of federal bond income based on its reading of this Court's decision in *Memphis Bank*. Consequently, the Tennessee Supreme

Court's decision places this Court's decision in *Memphis Bank* into conflict with the decision in *Bartow* and the principles reaffirmed in that case.

The Tennessee Supreme Court misapplied this Court's decision in *Memphis Bank* when it utilized the nondiscrimination standard from that case to decide the extent of the proper deduction of federal bond income which is required by 31 U.S.C. §3124(a). *Memphis Bank* did not consider the scope of the exemption provided for federal bonds and their income by 31 U.S.C. §3124(a).

The nondiscrimination standard of 31 U.S.C. §3124(a) requires that taxes measured against federal bond income must be equal to the taxes imposed on state bond income and if the taxes imposed on such income are not equal, the tax on the federal bond income is barred. In this case, federal bond income cannot be taxed under the Tennessee Excise Tax because the tax does not come within the exception in 31 U.S.C. §3124(a) for nondiscriminatory franchise taxes. However, the Tennessee statute is in compliance with 31 U.S.C. §3124(a) when federal bond income is removed from the tax base to the extent that it was taxed. The exclusion of the net federal bond income fully immunizes the federal bond income from tax. Further, after the net federal bond income is removed from the net earnings tax base, the holding of federal bonds does not increase a taxpayer's tax on his other income nor does it decrease the tax on other income.

The Tennessee Supreme Court has effectively held that 31 U.S.C. §3124(a), as applied by this Court in *Memphis Bank*, provides an exemption which is broader than just the immunity of federal bonds or their income. It has held that 31 U.S.C. s3124(a) requires that federal bond holders be provided both an immunity for their federal bond income and also a tax shelter for holding federal bonds.

Bartow dealt with the same question presented here

— the amount of the deduction with respect to federal bonds necessary to comply with 31 U.S.C. §3124(a). In *Bartow,* the taxpayers asked for deductions relative to their federal bonds which created tax shelters that were in addition to the requirement to exempt the federal bonds or their income from taxation. The only difference from the present case is that *Bartow* applied 31 U.S.C. §3124(a) to a property tax which utilized a net worth tax base. Since the principles reaffirmed in *Bartow* were derived from income tax cases, the decision should also apply to income based taxes. In the present case, the tax base is a net earnings tax base but, similarly, the Respondents claim a gross deduction which likewise results in a tax shelter.

The Respondents claim not only a refund of the taxes paid with respect to federal bond income. They claim, in addition, a tax shelter which will completely shield their entire net earnings from taxable sources and result in a refund of all taxes paid on those taxable earnings. The effect of the Respondents' gross deduction is that the entire net earnings tax base is completely eliminated in essentially the same way that the net worth tax base in *Bartow* was eliminated by the taxpayers' proposed gross deduction. This method of deduction would shelter virtually all banks from similar taxes measured on net earnings.[1] This Court's ruling in *Bartow* was explicitly aimed at preventing this type of result. 470 U.S. at 595.

Is this tax shelter benefit secured to the Respondents by 31 U.S.C. §3124(a) or the United States Constitution? A negative answer to this question, we believe, is required by this Court's decision in *Bartow. Bartow* held that the

[1]The 1982 Statistics on Banking prepared by the Federal Deposit Insurance Corporation, at page 72 (See Appendix p. A-29) indicates that in 1982 the gross interest income on federal obligations held by the banks was $21,125,000,000 whereas the net income before income taxes and security gains and losses was $19,244,000,000.

exemption provided by 31 U.S.C. §3124(a) is satisfied when federal bonds are removed from a state tax base to the extent to which said bonds were included in the tax base.

In a unanimous opinion in *Bartow,* this Court affirmed the principle that tax exempt income is fairly charged with its related expenses in determining the amount of income immune from tax and the principle that the federal immunity doctrine as codified in 31 U.S.C. §3124(a) is not a tax shelter. Those two principles properly limit the federal immunity doctrine so that it does not confer a special status on a party dealing with the federal government such that he can shelter his admittedly taxable transactions from tax through implied affirmative benefits such as the tax shelter sought by the Respondents in this case.

Further, this Court said in *Bartow*:

> The full deduction therefore did more than immunize the [federal] bonds from taxation; it "confers upon that ownership an affirmative benefit at the expense of the taxing power of the state, by relieving the taxpayer from the full burden of taxation on net worth to which his taxable assets have in some measure contributed."

470 U.S. at 590.

Thus, the Tennessee Supreme Court's misapplication of federal law has provided the tax shelter described above to the Respondents at the expense of the taxing power of the State and, thereby has imposed an unwarranted restriction on the manner in which the State of Tennessee can exercise its taxing power. The affirmative benefit of such a tax shelter is not required by 31 U.S.C. §3124a nor by the Constitution. Consequently, this Court should grant this petition to eliminate the confusion which the Tennessee Supreme Court's ruling creates concerning the constitutional rule regulating state taxation of federal securities.

2. This Court Needs to Correct the Tennessee Su-

preme Court's Misapplication of Federal Law Which Would Seriously Impede the Ability of the State of Tennessee and Other States to Structure Equitable Tax Systems While Exempting Federal Bonds or Their Income.

The issues presented by this case are significant and potentially far reaching. The Tennessee Supreme Court's ruling departs from the longstanding federal-state relationship which has been recognized by this Court in the area of federal immunity. The determination of the validity of the Tennessee Supreme Court's ruling is of substantial importance to the states which exempt federal bond income from income based taxes.[2] It is also important for many other kinds of taxes. For example, several states have insurance premium taxes which are imposed on gross premiums earned with respect to an insurance company's business in the taxing state. If the company invests in property within the state, such as state bonds, the company receives a reduction in its rate of tax.[3] Federal bonds are not taxed at all under such taxes, however, it is arguable that the Tennessee Supreme Court's decision would require that the company receive a reduction in its tax rate for owning federal bonds. This case provides this Court with an opportunity to clarify whether its ruling in *Bartow* is limited to property taxes or whether that decision extends to include income and other forms of taxation.

The Tennessee Supreme Court's interpretation of 31 U.S.C. s3124(a) creates a substantial restriction on the free exercise of the state's taxing power when it concludes that

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[2]The [1985] Multistate Corporate Income Tax Guide (CCH), ¶75 indicates that 32 states exempt federal bond income from income based taxes.

[3]See for example, Tenn. Code Ann. §56-4-210, Idaho Code §41-403, La. Rev. Stat. Ann. §22:1068, Mont. Rev. Codes. Ann. §33-2-705, 36 Okla. Stat. Ann. §625, Vernon's Ann. Civ. St., Article 7064, W.Va. Code §33-3-14b.

a tax shelter relative to federal bonds is required by implication.[4] This tax shelter is at the expense of the state's taxing power and inconsistent with the past history of this doctrine. Since *McCullough v Maryland,* 17 U. S.(4 Wheat.) 316 (1819), the states have been free to structure their tax systems without restriction by the Federal Immunity Doctrine, provided that they do not attempt to tax directly or indirectly federal functions. Chief Justice Marshall considered that the proper boundary for determining the scope of a state's taxing power was the extent of the state's sovereignty. 17 U. S.(4 Wheat.) at 429-430.

It is proper and a legitimate exercise of state sovereignty to encourage investment in state bonds or to benefit certain classes of taxpayers such as banks. In this case, only banks enjoy this special benefit relative to state bonds. It is certainly appropriate to regulate the manner in which the states tax federal obligations; however, when the States do not tax federal bonds or their income, the States should be free to exercise their sovereign right to structure their tax systems in the ways deemed necessary to carry out their responsibilities to provide for the welfare of their citizens.

In *Metcalf & Eddy v Mitchell,* 269 U.S. 514 (1926) this Court stated that the doctrine of intergovernmental immunity should be applied in a practical way, so that each government shall be permitted to exercise its taxing power to the fullest extent possible. This Court said:

> But neither government may destroy the other, nor curtail in any substantial manner the exercise of its powers. Hence, the limitation upon the taxing power of each, so far as it affects the other, must receive a practical construction which permits both to function with the minimum of interference each with the other;

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[4]On this issue, suits have been brought against the State of Tennessee by 42 banks seeking refunds totaling approximately $10,000,000.

and that limitation cannot be so varied or extended as seriously to impair the taxing power of the government imposing the tax.

269 U.S. at 523-524.

This Court should grant this petition to prevent an erosion of the scope of the taxing power of the states by a decision which is contrary to the requirements of 31 U.S.C. §3124(a) and the Constitution.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that three true and exact copies of the foregoing Petition have been mailed on this the 29th day of December, 1986 to the below-referenced counsel:

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APPENDIX

APPENDIX

APPENDIX A

IN THE SUPREME COURT OF TENNESSEE
AT JACKSON

MIDLAND BANK & TRUST COMPANY, UNION PLANTERS NATIONAL BANK, NATIONAL BANK OF COMMERCE, COMMERCIAL AND INDUSTRIAL BANK,	Shelby Equity
Appellees	Honorable D. J. Alissandratos
VS.	Judge
MARTHA B. OLSEN, Commissioner of the Department of Revenue, for the State of Tennessee, Appellant	

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OPINION

TRIAL COURT AFFIRMED
CASE REMANDED — WM. H. D. FONES, JR.

The Commissioner of Revenue appeals from a decree of the trial court awarding four Memphis banks recovery of 1982 corporate excise taxes, paid under protest, attributable to the inclusion of interest earned on obligations of the United States.

The result was mandated by the decision of the United States Supreme Court in *Memphis Bank & Trust v. Garner,* 459 U.S. 392, 103 S.Ct. 692 (1983), and the unpublished opinion of this Court in that case following remand.[1]

In *Garner,* plaintiff bank sought recovery of the local bank tax paid under protest for the years 1977-78, imposed by Acts of 1977, chapter 140, codified in T.C.A. §67-751-763. That act required each bank doing business in Tennessee to pay local governments three percent of the net earnings for the next preceding fiscal year and directed that, "The net earnings shall be calculated in the same manner as prescribed by T.C.A. Title 67, chapter 27." The United States Supreme Court concluded that net earnings as defined in T.C.A. 67-2704 produced the following result:

> Under the statute, net earnings include interest received by the bank on the obligations of the United States and its instrumentalities, as well as interest on bonds and other obligations of states other than Tennessee, but exclude interest on obligations of Tennessee and its political subdivisions.[3]

[3]For purposes of the bank tax, the term "net earn-

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[1]*Memphis Bank and Trust v. Garner,* filed February 27, 1984, at Jackson, Tennessee.

ings" is defined as "[f]ederal taxable income" with specified adjustments. Tenn. Code Ann. §67-2704 (Supp. 1982). "Federal taxable income" includes interest on obligations of the United States and its instrumentalities, but does not include interest on state or municipal obligations. See 26 U.S.C. §103(a). Tennessee Code Ann. §67-2704(b)(2)(B) adjusts "federal taxable income" by adding "[i]nterest income earned on bonds and other obligations of other states or their political subdivisions, less allowable amortization." However, no similar adjustment is made to include interest on obligations of the State of Tennessee or its political subdivisions in the definition of "net earnings" subject to the bank tax.

459 U.S. at 394.

The single issue considered by the United States Supreme Court in *Garner* was whether the Tennessee local bank tax was a "nondiscriminatory franchise or other nonproperty tax in lieu thereof," under 31 U.S.C. §742. That section has been treated as a restatement of the constitutional rule of federal tax immunity established in *McCulloch v. Maryland,* 4 Wheat. 316 (1819). *See Memphis Bank & Trust v. Garner,* 459 U.S. at 397.

The conclusion reached in *Garner* was as follows:

> It is clear that under the principles established in our previous cases, the Tennessee bank tax cannot be characterized as nondiscriminatory under §742. Tennessee discriminates in favor of securities issued by Tennessee and its political subdivisions and against federal obligations. The State does so by including in the tax base income from federal obligations while excluding income from otherwise comparable state and local obligations. We conclude, therefore, that the Tennessee bank tax impermissibly discriminates against the Fed-

eral Government and those with whom it deals.

459 U.S. at 398-99.

The 1982 tax at issue in the case presently before the Court was calculated in accord with the definition of net earnings in T.C.A §67-2704, unchanged from the definition condemned as discriminatory in *Garner*. Here, it was collected by the State as a general corporate excise tax, whereas in *Garner* the tax was payable to county and municipal governments, a difference of no significance. In *Commerce Union Bank v. State Board of Equalization*, 615 S.W.2d 151 (1981), we said, with respect to the local bank tax involved in *Garner:*

> Nevertheless it is a corporate excise tax and must be so regarded and administered. Rules and regulations regarding the calculation and administration of the regular corporate excise tax are pertinent, because the tax is to be calculated in the same manner as that tax.

615 S.W.2d at 152.

The local bank tax, T.C.A. §67-751-763, was repealed by Public Acts 1983, chapter 227. T.C.A. §67-2704, now codified as §67-4-805 has been amended so as to include in the calculation of taxable earnings, Tennessee obligations and federal obligations thus achieving the equality of treatment mandated in *Garner*.

The Commissioner contends that in *First National Bank of Atlanta v. Bartow County Bd. of Tax Assessors*, ___U.S. ___, 105 S.Ct. 1516 (1985) the United States Supreme Court authorized a formula for the exclusion of interest earned on federal obligations that should be employed in this case that would substantially reduce the recovery of plaintiff banks.

The short answer to that contention is that *Bartow* involved the *extent of the exemption* of federal obligations that a state must grant under 31 U.S.C.

3124(a).[2] No discriminatory issue existed in *Bartow* as both Georgia obligations and federal obligations were included in the base of the tax. In *Garner* and the case at bar, discrimination was the issue, not the scope of the exemption. In addition, the tax in *Bartow* was a property tax whereas the tax in *Garner* and the present case is a "franchise or other non-property tax,"[3] and as such would be excluded from the exemption test set forth in 31 U.S.C. 3124(a) [formerly 31 U.S.C. 742(a)] *if* found to be nondiscriminatory. Having been adjudged discriminatory by the United States Supreme Court because of the total exclusion of Tennessee obligations, the federal obligations must be given identical treatment and the *Bartow* formula is clearly inapplicable.

If the Tennessee Corporate Excise Tax was a property tax and if this Court had the power to amend T.C.A. §67-2704 so as to include Tennessee obligations in the base of the tax along with federal obligations, then we could authorize use of the *Bartow* formula. We rejected an invitation by the Commissioner to amend that section in our unpublished opinion of February 27, 1984 in *Garner,* as follows:

> In the alternative, appellants ask this Court to

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[2]31 U.S.C. 3124(A), enacted September 13, 1982, revised, "without substantial change" 31 U.S.C. 742(a), the exemption and nondiscriminatory statute applied in *Garner* in holding the Tennessee local bank tax was unconstitutional as discriminatory, with no consideration of the scope of the exemption.

[3]In *Garner,* the United States Supreme Court held it unnecessary to determine whether the Tennessee local bank tax was a franchise tax or another non-property tax, because, "the nondiscrimination requirement applies to both franchise taxes and other non-property taxes." 459 U.S. at 396, footnote 6. It is thus inescapable that the United States Supreme Court has characterized the tax at issue as a non-property tax.

elide from the general corporate excise tax statutes in force at all times material to this litigation the exemption from taxation of state securities so as to include as net earnings interest on both state securities and federal securities. This, of course, is entirely contrary to the provisions contained in the corporate excise tax statutes. It amounts to the imposition by statutory construction of a tax on earnings which the Legislature specifically exempted and which were not required at any time pertinent to this litigation to be included for taxation. It is our opinion that the doctrine of elision does not authorize this Court to remove the exemption of state securities contrary to express legislative direction and to subject them to taxation, even though the exemption itself has been held to be discriminatory.

We continue to adhere to that ruling.

The Commissioner urges the Court to give the *Garner* decision a prospective only application.

A ruling which is purely prospective governs future cases and does not apply even to the parties before the Court. *Linkletter v. Walker*, 381 U.S. 618, at 621-22, 85 S.Ct. 1731, at 1733, (1965). However, the United States Supreme Court, and this Court, have frequently applied a ruling to the parties before the Court and on some occasions to the parties before the Court and those having cases in the pipeline. *See, e.g., Mapp v. Ohio,* 367 U.S. 643, 81 S.Ct. 1684; *Linkletter v. Walker, supra;* and *Luna v. Clayton*, 655 S.W.2d 893 (Tenn. 1983); *Cumberland v. Capital Corp. v. Patty,* 556 S.W.2d 516 (1977).

The Commissioner of Revenue was a party to *Garner* and on remand of that case to this Court, subsequent to January 23, 1983, raised numerous defenses, but did not raise the issue of prospective/retrospective application of the United States Supreme Court's deci-

sion. The plaintiffs in that case were allowed to take advantage of the *Garner* decision.

In the present case, the Commissioner implies, without presenting any argument or authority, that the 1982 excise tax involved here would require retrospective application of *Garner* in order to allow these plaintiffs to recover. In our opinion allowing recovery in this case does not involve a retrospective application of *Garner* but to the contrary involves a prospective application. The 1982 tax was not due when *Garner* was rendered and the cause of action of these plaintiffs to contest the constitutionality of the discriminatory assessment of 1982 taxes did not accrue until they paid their 1982 taxes under protest, which they did subsequent to the ruling in *Garner*. They filed suit on June 30, 1983, within the period of limitation following payment prescribed by law. In our opinion, the date that determines prospective or retrospective application of a judicial decision is the date that the cause of action accrues, not the end of the tax year involved.

A direct analogy exists between the issue here, whether the end of the tax year or the accrual of the cause of action governs the prospective/retrospective application, and the position of tort plaintiffs who were caught in the *Jackson v. General Motors*[4] dilemma of having their cause of action barred by a statute of limitations before the cause of action accrued. In *McCroskey v. Bryant*, 524 S.W.2d 487 (Tenn.1975), we applied the principle that a statute of limitations does not begin to run until a cause of action accrues to overrule *Jackson*. Reason and logic dictate the application of that principle to the issue whether the actions of these plaintiffs are in a pre-*Garner* or post-*Garner* position. We therefore hold that allowing these plaintiffs to recover 1982 taxes due and paid subsequent to January 23, 1983, does not involve a retroactive applica-

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[4]223 Tenn. 12, 441 S.W.2d 482 (Tenn.1969).

tion of *Garner* and is consistent with our application of the United States Supreme Court's decision in that case to the parties before the Court.

We have given careful consideration to the Commissioner's reliance upon *First of McAlester Corp. v. Oklahoma Tax Commission*, 709 P.2d 1026 (Okla. 1985). The Oklahoma court had 268 appeals pending before it seeking refunds of Oklahoma bank excise taxes in reliance upon *Garner*. At least some of the claims were for taxable years from 1971 through 1981. The opinion recites that some of the appellants asserted that they would file 1982 returns excluding interest in reliance on *Garner*, but the decision is silent as to whether it considered 1982 taxes as prospective or retrospective. We therefore do not find the Oklahoma court's reasoning in applying *Garner* prospectively relevant to this case because the issue of retroactive application for tax years earlier than 1982 is not before us and is expressly reserved.

The decree of the trial court is affirmed and this case is remanded for further proceedings according to law. Costs are adjudged against the Commissioner of Revenue.

Wm. H. D. Fones,
Justice

Concur:

Brock, C.J.
Cooper, Harbison, Drowota, JJ.

APPENDIX B

IN THE SUPREME COURT OF TENNESSEE
AT JACKSON

MIDLAND BANK &
TRUST COMPANY,
UNION PLANTERS
NATIONAL BANK,
NATIONAL BANK OF
COMMERCE,
COMMERCIAL &
INDUSTRIAL BANK,

Appellees,

VS.

MARTHA B. OLSEN,
COMMISSIONER
OF THE DEPARTMENT
OF REVENUE,
FOR THE STATE OF
TENNESSEE

Appellant.

SHELBY EQUITY NO. 3
(No. 90305-3 Below)

AFFIRMED & REMANDED.

JUDGMENT

This cause coming on to be heard upon the record on appeal from the Chancery Court of Shelby County, briefs and argument of counsel; upon consideration whereof, this Court is of opinion that in the decree of the Chancellor there is no reversible error.

In accordance with the opinion of the Court filed herein, it is therefore, ordered and adjudged by this Court that the decree of the Chancellor is affirmed. The cause is remanded to the trial court for further proceedings according to law.

Costs are adjudged against the Commissioner of Revenue.

9/29/86.

APPENDIX C

IN THE CHANCERY COURT OF SHELBY COUNTY, TENNESSEE

MIDLAND TRUST COMPANY,
UNION PLANTERS NATIONAL BANK,
NATIONAL BANK OF COMMERCE,
COMMERCIAL AND INDUSTRIAL BANK,

Plaintiffs,

No. 90305-3

v.

MARTHA B. OLSEN,
Commissioner of the Department of Revenue, for the State of Tennessee,

Defendant.

ORDER

This cause came on to be heard on September 13, 1985, before the Honorable D. J. Alissandratos, Chancellor of the Chancery Court of Shelby County, Tennessee, Part III, upon the complaint, as amended, filed by the Plaintiffs; upon the answer, defenses and countercomplaint filed by Defendant; upon the answer, as amended, of the counterdefendants; upon agreed orders for dismissal of two Plaintiffs originally in this cause; upon the affidavits filed by Plaintiffs and Defendant in this cause; upon motion by Plaintiffs for summary judgment; upon the statements of counsel for the Plaintiffs and counsel for the Defendant; and upon the entire record in this cause; and

IT APPEARS to the Court and the Court finds that the Plaintiffs' motion for summary judgment should be granted and that Defendant's defenses and countercomplaint should be denied for the following reasons:

1. Pursuant to *Memphis Bank & Trust Company v. Garner*, 459 U.S. 392 (1983), and the rulings of this Court and the Tennessee Supreme Court in said case, neither revival nor elision are proper and therefore Defendant's defenses and counterclaims thereon are denied.

2. The remedy proposed by Defendants, exclusion of only the net amount of federal interest income from the tax, would not eliminate the discrimination in the excise tax that exists in favor of Tennessee obligations and against federal obligations. Such a partial remedy would only alter the degree of that discrimination, since the gross amount of Tennessee interest income would be excluded from the tax base but only the net amount of federal interest income would be excluded from the tax base. 31 U.S.C. §742 (now 31 U.S.C. §3124(a)) and the Constitution of the United States require, in order to remove discrimination in favor of Tennessee obligations, that the full amount (and not merely the net amount) of interest from obligations of the United States and its instrumentalities be excluded from the excise tax base.

IT IS, THEREFORE, ORDERED, ADJUDGED, AND DECREED:

1. That Plaintiffs' motion for summary judgment be and is hereby granted and Defendant's defenses and countercomplaint be and are hereby denied for the reasons set forth above.

2. That Plaintiffs should have and recover a judgment against the Defendants for excise tax payments by Plaintiffs attributable to the inclusion of the full amount of interest from obligations of the United States and its instrumentalities in the excise tax base and further that Plaintiffs recover from Defendant all prejudgment and postjudgment interest provided for by law;

3. That costs are assessed against the Defendant, for all of which execution shall issue forthwith.

CHANCELLOR
Date: 10/14/85
Approved:

David C. Scruggs
81 Monroe, Suite 600
Memphis, Tennessee 38103
Attorney for Plaintiffs

Joe C. Peel
450 James Robertson Parkway
Nashville, Tennessee 37219
Attorney for Defendants

CERTIFICATE OF SERVICE

The undersigned hereby certifies that a copy of the foregoing Order was served upon Joe C. Peel, Assistant Attorney General, 450 James Robertson Parkway, Nashville, Tennessee 37219, via United States Postal Service, postage prepaid, this 13th day of October, 1985.

/s/ Frank N. Carney

APPENDIX D

IN THE CHANCERY COURT OF SHELBY COUNTY, TENNESSEE

MIDLAND BANK &
TRUST COMPANY,
UNION PLANTERS
NATIONAL BANK,
NATIONAL BANK OF
COMMERCE,
COMMERCIAL AND
INDUSTRIAL BANK,

Plaintiffs,

No. 90305-3

v.

MARTHA B. OLSEN,
Commissioner of the
Department of Revenue, for
the State of Tennessee,

Defendant.

ORDER AND FINAL JUDGMENT

This cause came on to be heard on December 6 and December 20, 1985, before the Honorable D. J. Alissandratos, Chancellor of the Chancery Court of Shelby County, Tennessee, Part III, upon the Motion to Rehear And/Or Reconsider, the Motion to Determine Damages filed by Defendant, Plaintiffs' Motion to Determine Interest Rate for Prejudgment Interest, the Responses to said Motions filed by the Plaintiffs and upon the statements of counsel for the Plaintiffs and counsel for the Defendant;

IT APPEARS to the Court and the Court finds that the Defendant's Motion to Rehear And/Or Reconsider should be denied.

IT APPEARS to the Court and the Court finds that the Plaintiffs' Motion for Summary Judgment has been granted by Order dated October 14, 1985, and that final judgment thereon should be granted in favor of Plaintiffs in the amounts set forth herein;

IT IS, THEREFORE, ORDERED, ADJUDGED AND DECREED:

1. That Defendant's Motion to Rehear and/or to Reconsider is denied.

2. That the Plaintiffs have and recover from the Defendant as follows:

A. Plaintiff, Midland Bank & Trust Company is hereby awarded a judgment against the Defendant in the amount of $69,262 prejudgment legal interest in the amount of $16,223, for the period April 1, 1983 through December 6, 1985, plus post-judgment legal interest computed on the principal and prejudgment interest at the rate of 10% for the period December 7, 1985 until the date of payment.

B. Plaintiff, Union Planters National Bank, is hereby awarded a judgment against the Defendant in the amount of $454,618, plus prejudgment legal interest of $105,176 for the period April 1, 1983 through December 6, 1985, plus postjudgment legal interest computed on the principal and prejudgment interest at the rate of 10% for the period December 7, 1985 until the date of payment.

C. Plaintiff, National Bank of Commerce, is hereby awarded a judgment against the Defendant in the amount of $240,846, plus prejudgment legal interest of $56,316, for the period April 1, 1983 through December 6, 1985, plus postjudgment legal interest computed on the principal and prejudgment interest at the rate of 10% for the period December 7, 1985 until the date of payment.

D. Plaintiff, Commercial and Industrial Bank, is hereby awarded a judgment against the Defendant in the amount of $128,407, plus prejudgment legal interest of

$30,281, for the period April 1, 1983 through December 6, 1985, plus postjudgment legal interest computed on the principal and prejudgment interest at the rate of 10% for the period December 7, 1985 until the date of payment.

3. That costs are assessed against the Defendant, for all of which, execution shall issue forthwith.

CHANCELLOR
Date: 12/20/85

APPROVED:

David C. Scruggs
81 Monroe, Suite 600
Memphis, Tennessee 38103
Attorney for Plaintiffs

Joe C. Peel
450 James Robertson Parkway
Nashville, Tennessee 37219
Attorney for Defendant

APPENDIX E

IN THE SUPREME COURT OF TENNESSEE AT JACKSON

Not designated for publication
February 27, 1984

MEMPHIS BANK & TRUST COMPANY,

Plaintiff-Appellee,

vs.

RILEY C. GARNER, SHELBY COUNTY TRUSTEE, AND GLENN E. FOSTER, TREASURER OF THE CITY OF MEMPHIS, TENNESSEE,

Defendants-Appellants,

and

WILLIAM M. LEECH, JR., ATTORNEY GENERAL FOR THE STATE OF TENNESSEE,

Intervening Defendant-Appellant.

Shelby Equity
Hon. D. J. Alissandratos, Chancellor

For Plaintiff-Appellee:

David C. Scruggs
Andrew H. Raines
Frank N. Carney
Ernest G. Kelly, Jr.
(Memphis, TN)

For Defendants-Appellants:

J. Minor Tait, Jr.
Memphis, TN
(for Riley C. Garner)

William C. Bateman, Jr.
Memphis, TN
(for Glenn E. Foster)

Joe C. Peel
Assistant General Attorney
(for the Attorney General)

OPINION

AFFIRMED AND REMANDED PER CURIAM

This action was brought for the recovery of local bank excise taxes paid under protest for the years 1977 and 1978. At issue between the parties was the inclusion for taxation of interest on certain federal securities. It was stipulated that if this interest was not properly taxable, appellee was entitled to a refund of the taxes paid under protest.

The statutes imposing the tax in question were construed by this Court in the case of *Commerce Union Bank v. State Board of Equalization*, 615 S.W.2d 151 (Tenn. 1981), while the present litigation was in process but after the original decision of the Chancellor. These statutes were codified in T.C.A. §§67-751 to 763. They were repealed by 1983 Tenn. Pub. Acts, ch. 227.

The excise tax on net earnings of a bank were to be "calculated in the same manner as prescribed by chapter 27 of title 67." T.C.A. §67-751.

The statutes referred to were those imposing the general corporate excise tax. At all times relevant to this litigation those statutes defined net earnings as "federal taxable income" subject to certain deductions and exemptions. T.C.A. §67-2704 (now 67-4-805). Although since revised, at that time the statutes had the effect of including in taxable earnings interest on federal securities but exempting interest on Tennessee state and local securities.

In prior proceedings in the present litigation, the Supreme Court of the United States held that the provisions of the general state excise tax law improperly discriminated against holders of federal securities in contravention of certain federal statutes. *Memphis Bank & Trust Co. v. Garner*, U.S. , 74 L. Ed. 2d 562, 103 S. Ct. 692 (1983). The cause was remanded to the state courts for further proceedings.

It was never contended in this litigation that the local bank excise tax or the general state corporate excise tax statutes were invalid in toto, nor did the Supreme Court of the United States so indicate.

Appellants urged in the trial court and also urge in this Court that in view of the invalidity of the exemption of the interest on Tennessee securities, and the consequent discrimination against holders of federal securities, this Court should hold the entire local bank excise tax statutes invalid and thereby effect a revival of previous statutes imposing taxes upon shares of stock in banks. We find no basis for the application of such a principle here. The entire local bank tax statutes have not been invalidated, but only that portion purporting to include interest on federal securities while exempting state securities. We do not deem the doctrine of revival applicable under those circumstances.

In the alternative, appellants ask this Court to elide from the general corporate excise tax statutes in force at all times material to this litigation the exemption from taxation of state securities so as to include as net earnings interest on both state securities and federal securities. This, of course, is entirely contrary to the provisions contained in the corporate excise tax statutes. It amounts to the imposition by statutory construction of a tax on earnings which the Legislature specifically exempted and which were not required at any time pertinent to this litigation to be included for taxation. It is our opinion that the doctrine of elision does not authorize this Court to remove the exemption of state securities contrary to express legislative direction and to subject them to taxation, even though the exemption itself has been held to be discriminatory.

Under the circumstances it is our opinion that the Chancellor correctly held that interest on federal securities could not properly be included in net earnings for purposes of the general corporate excise tax or of the local bank tax involved here, under the holding of the Supreme Court of the United States, and that appellant was entitled to the

refund claimed in view of the stipulation of the parties. We affirm that decision and remand the case to the trial court for enforcement of the judgment and for any further proceedings which may be necessary. Costs on appeal are taxed equally to Riley C. Garner, Shelby County Trustee, and Glenn E. Foster, Treasurer of the City of Memphis, All other costs will be assessed by the Chancellor.

PER CURIAM

APPENDIX F

Tennessee Code Annotated Section No. 67-2704.

(a) The term "net earnings" is defined, at the option of the taxpayer, as:

(1) Federal taxable income before the operating loss deduction and special deductions provided for in Sections 241 - 247 and 249 - 250 of the Internal Revenue Code [24 U.S.C. Sections 241 - 247, 249, 250] prior to its amendment by the Economic Recovery Tax Act of 1981, Public Law No. 97-34, Sections 201-109; or

(2) Federal taxable income before the operating loss deduction and special deductions provided for in Sections 241 - 247 and 249 - 250 of the Internal Revenue code [24 U.S.C. Sections 241 - 247, 249, 250] after its amendment by the Economic Recovery Tax Act of 1981, Public Law No. 97-34, Sections 201-209, plus one-tenth (1/10) of all depreciation used in computing federal taxable income.

(b) The term net earnings as defined in subsection (a) shall be subject to the following adjustments:

(1) There shall be added to the federal taxable income:

(A) Excise tax imposed by this state to the extent deducted in determining federal taxable income.

(B) Interest income earned on bonds and other obligations of other states or their political subdivisions less allowable amortization.

(C) Any deduction made pursuant to Sections 611-617 of the Internal Revenue Code to the extent the deduction when added with similar deductions in prior years exceeds the cost of the property.

(D) Gains not recognized pursuant to Section 337 of the Internal Revenue code.

(E) The charitable contributions deduction claimed under Section 170 of the Internal Revenue Code.

(F) Any capital loss carrybacks or carryovers deducted pursuant to Section 1212(a) of the Internal Revenue Code.

(G) Any expense or depreciation permitted as a deduction in computing federal taxable income solely as a result of lease characterizations permitted under Section 168 of the Economic Recovery Tax Act of 1981 which would not have been permitted in the absence of such act; it being the legislative intent that excise tax revenue not be reduced due to lease characterizations made for the purpose of transferring investment tax credits and depreciation allowances from one business entity to another.

(2) There shall be subtracted from the federal taxable income:

(A) Dividends earned by a parent corporation from a subsidary corportion where such parent owns eighty percent (80%) or more of the stock of the subsidary.

(B) Any amount included in federal taxable income but not taxable under the law of this state.

(C) Any net operating loss incurred, which is defined as the excess of allowable deductions over total income allocable to this state for the year of the loss, and which may be carried over and allowed in the succeeding tax years until fully utilized in the next succeding taxable year or years in which the taxpayer has net income, but in no case for more that three (3) years after the taxable year in which the net operating loss occurs.

(D) A portion of the gain or loss of the sale or other disposition of property having a higher basis for Tennessee Excise tax purposes than federal income tax purposes measured by the difference in the Tennessee basis and the federal basis.

(E) Actual charitable contributions make by the corporation during the fiscal year.

(F) Losses not deducted pursuant to §337 of the Internal Revenue Code.

(G) Any capital losses incurred during the fiscal year and not deductible under s1211(a) of the Internal Revenue Code.

(H) Any expense, other than income taxes, not deducted in determing federal taxable income for which a credit against the federal income tax is allowable. This subdivision shall apply to taxable periods ending on and after December 31, 1977.

(I) Any amount included in federal taxable income solely as a result of lease characterizations permitted under Section 168 of the Economic Recovery Tax Act of 1981 which would not have been permitted in the absence of such act.

(J) Any amount of depreciation or other expense which the taxpayer could have deducted in computing federal taxable income had it not made the election to enter into a lease transaction permitted under Section 168 of the Economic Recovery Tax Act of 1981 which would not have been permitted in the absence of such act.

DENY DEDUCTION FOR INTEREST TO CARRY TAX-EXEMPT BONDS

Current Law

Current law generally denies a deduction to any taxpayer for interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations. Whether indebtedness is incurred or continued to purchase or carry tax-exempt obligations is based on the taxpayer's purpose in incurring indebtedness while holding tax-exempt obligations, as indicated by the facts and circumstances of the particular case.

Until 1982, banks, thrifts, and certain other financial institutions could invest their depository funds in tax-exempt obligations without losing the deduction for interest paid on their deposits or short-term obligations. Under current law, however, such financial institutions are denied 20 percent of their interest deduction allocable to indebtedness (including deposits and other short-term obligations) incurred or continued in order to purchase or to carry tax-exempt obligations acquired after 1982. For this purpose, a statutory presumption treats a portion of a bank's or other financial institution's indebtedness as allocable to tax-exempt obligations in an amount equal to the ratio of (i) the average adjusted basis over the year of all tax-exempt obligations (acquired after 1982) held by the bank or financial institution to (ii) the average adjusted basis over the year of all assets held by the bank or financial institution.

Reasons for Change

Basic measurement of income principles require that income be matched with the costs of its production. In line with these principles, the costs of producing tax-exempt income, including interest expense incurred to carry tax-exempt bonds, are properly nondeductible. Since the income to which such costs are attributable is exempt from tax,

disallowance of a deduction is necessary to prevent the taxpayer from offsetting other nonexempt income.

The exception from the above principles for interest paid or incurred by commercial banks and thrifts has enabled these institutions to hold a substantial portion of their investment portfolios in tax-exempt obligations, substantially reducing their Federal tax liability. The full allowance of interest deductions to banks holding tax-exempt obligations contributed to the relatively low effective tax rates of banks. In 1981, prior to the changes reflected in current law, commercial banks paid only $926 million of Federal income tax on approximately $15 billion of net income.

In addition, the special rule for commercial banks and thrifts provides them with a competitive advantage over other financial institutions that are disallowed interest deductions for carrying tax-exempt obligations. Broker and dealers currently are not allowed to deduct any portion of the interest paid to purchase or to carry tax-exempt securities. Similarly, life insurance companies must prorate their tax-exempt investment income between policyholders and the company, which is comparable to denying a deduction for interest incurred to carry tax-exempt obligations.

Proposal

Banks, thrifts and the other financial institutions favored under current law would be denied a deduction for 100 percent of their interest payments allocable to the purchase or carrying of tax-exempt obligations. The portion of a financial institution's interest payments that would be deemed allocable to the purchase or carrying of tax-exempt obligations would be the same as under current law. Thus, such portion would be equal to the ratio of (i) the average adjusted basis over the year of all tax-exempt obligations (acquired on or after January 1, 1986) held by the financial institution to (ii) the average adjusted basis over the year of all assets held by the financial institution. For example,

if a bank holds $1,000,000 of tax-exempt bonds acquired after January 1, 1986, (measured by their average adjusted basis over the year) and $3,000,000 of other assets (similarly measured), its otherwise allowable interest deduction would be reduced by 25 percent without regard to whether paid to depositors, short-term obligors, or long-term obligors. As under current law, the prorata presumption would be irrebuttable.

Effective Date

The proposal would be effective for interest allocable to tax-exempt obligations acquired on or after January 1, 1986. The current disallowance rule of 20 percent would continue to apply after December 31, 1985 to tax-exempt obligations acquired between January 1, 1983 and December 31, 1985.

Analysis

The deductibility of interest paid to purchase or to carry tax-exempt bonds increases the attractiveness of tax-exempt obligations because of the attendant opportunity to shelter other taxable income. Moreover, present law encourages banks to make investments that are not economically attractive except for the tax benefits. For example, a bank may borrow at a nine percent interest rate and invest in tax-exempt obligations yielding only seven percent interest. Economically, the bank would lose two percent on the transaction; however, because the bank can deduct 80 percent of the interest paid, it pays an after-tax interest rate of only 5.7 percent ($9 \times [1-(.46 \times .8)]$) and makes an after-tax profit of 1.3 percent. Denying banks a deduction for interest allocable to the purchase or carrying of tax-exempt obligations would eliminate a tax incentive to make an otherwise unattractive economic investment.

Commercial banks hold one-third of outstanding tax-exempt securities and loans, as shown in Table 1. Commercial banks are the largest institutional investors, and are second only to households in total holdings of tax-exempt

obligations. Commercial banks are the major institutional investors because of their ability to borrow funds and deduct interest to carry investments that earn tax-exempt income. The transitional rule would continue to allow banks to deduct interest attributable to bonds acquired prior to the effective date, so that there would be no incentive to sell existing holdings. Banks would continue to buy some tax-exempt bonds after the effective date as evidenced by the current holdings of life insurance companies and brokers and dealers, who are already subject to the proposed rule.

Together with the reduction in marginal tax rates, this proposal would tend to reduce demand for tax-exempt bonds and exert upward pressure on tax-exempt interest rates, particularly short-term yields. Several of the Administration proposals, however, would have the opposite effect on the interest rates of tax-exempt obligations. The aggregate impact on tax-exempt interest rates is uncertain because the elimination of nongovernmental tax-exempt bonds, bonds issued for arbitrage purposes, and other tax shelters would tend to increase demand for the remaining governmental bonds and exert downward pressure on the interest costs paid by State and local governments.

Table 10.02-1

Distribution of Tax-Exempt Securities and Loans—1983

	Outstanding Tax-Exempt Bonds	
	Amount (In Billions)	Percent
Households	$ 173.8	35.9%
Nonfinancial Corporate Businesses	4.2	0.9
State and Local Government General Funds	9.7	2.0
Commercial Banks	162.4	33.5
Savings and Loan Associations	0.9	0.2
Mutual Savings Banks	2.2	0.4
Mutual Funds	31.5	6.4
Life Insurance Companies	10.0	2.1
State and Local Retirement Funds	1.8	0.4
Other Insurance Companies	86.7	17.9
Brokers and Dealers	1.4	0.3
Total	$ 484.6	100.0%

Office of the Secretary of the Treasury May 28, 1985

Source: Board of Governors of the Federal Reserve System *Flow of Funds Accounts, Assets and Liabilities Outstanding, 1960-83.*

APPENDIX H

Table 115. INCOME[1] OF INSURED COMMERCIAL BANKS IN THE UNITED STATES (STATES AND OTHER AREAS), 1977-1982

(Amounts in millions of dollars)

Income item	1977	1978	1979	1980	1981	1982
Operating income—total	**90,358**	**113,582**	**150,282**	**190,771**	**240,800**	**258,491**
Interest and fees on loans	58,991	76,182	102,192	126,954	163,510	167,196
Interest on balances with depository institutions	4,888	6,713	10,670	16,258	24,297	24,270
Income on federal funds sold and securities purchased under agreements to resell in domestic offices	2,476	3,682	6,126	8,764	12,270	11,392
Interest on U S Treasury securities and on obligations of other U S Government agencies and corporations	8,864	9,384	10,686	13,465	18,107	21,125
Interest on obligations of States and political subdivisions of the U S	5,365	6,039	6,955	8,172	9,704	10,661
Income from all other securities	969	1,095	1,198	1,438	1,639	1,727
Income from direct lease financing	699	862	1,073	1,371	1,746	1,943
Income from fiduciary activities	1,980	2,139	2,376	1,739	3,179	3,620
Service charges on deposit accounts in domestic offices	1,807	2,049	2,529	3,187	3,920	4,594
Other service charges, commissions, and fees	2,409	2,937	3,642	4,360	5,308	6,229
Other income[2]	1,910	2,499	2,835	4,063	5,119	5,732
Operating expenses—total	**78,792**	**98,480**	**132,391**	**171,267**	**228,576**	**239,247**
Salaries and employee benefits	16,346	18,744	21,562	24,675	28,044	31,424
Interest on time certificates of deposit of $100,000 or more issued by domestic offices	6,763	11,737	18,179	24,891	39,301	37,703
Interest on deposits in foreign offices	10,216	14,558	24,524	34,941	46,696	41,749
Interest on other deposits	21,833	23,918	29,185	38,588	53,450	62,288
Expense of federal funds purchased and securities sold under agreements to repurchase in domestic offices	4,543	7,264	12,356	16,770	23,879	20,724
Interest on demand notes issued to the U S Treasury and other borrowed money	816	1,458	3,167	4,387	5,904	6,218
Interest on subordinated notes and debentures	392	448	501	546	617	661
Occupancy expense of bank premises, net, and furniture and equipment expense	4,980	5,585	6,281	7,354	8,598	10,026
Provision for possible loan losses	3,301	3,525	3,786	4,479	5,069	8,343
Other operating expenses	9,599	11,244	12,849	14,635	17,018	20,112
Income before income taxes and securities gains or losses	**11,566**	**15,101**	**17,891**	**19,504**	**20,224**	**19,244**
Applicable income taxes	**2,832**	**4,162**	**4,742**	**5,019**	**4,624**	**3,657**
Income before securities gains or losses	**8,734**	**10,939**	**13,149**	**14,485**	**15,600**	**15,587**
Securities gains or losses, gross	**142**	**447**	**650**	**855**	**1,583**	**-1,280**
Applicable income taxes	43	222	300	362	726	-621
Securities gains or losses, net	98	225	350	492	857	-659
Income before extraordinary items	**8,833**	**10,714**	**12,799**	**13,992**	**14,744**	**14,927**
Extraordinary items, gross	**55**	**44**	**40**	**3**	**68**	**68**
Applicable income taxes	8	-1	1	14	12	-1
Extraordinary items, net	47	45	39	17	55	68
Net income	**8,879**	**10,760**	**12,838**	**14,009**	**14,799**	**14,996**

Source: 1982 Statistics on Banking, Federal Deposit Insurance Corporation.